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30 November 2011

By Post & Email:

Ms Karen Kemp
Executive Director (Banking Policy)
Hong Kong Monetary Authority
55/F, Two International Finance Centre
8 Finance Street, Central
Hong Kong

Dear Karen

Consultation on Proposed Regulatory Regime for the Over-the-counter Derivatives Market in Hong Kong

Thank you for your letter dated 17 October 2011 to our Chairman seeking the Association's comments on the proposed regulatory regime for the over-the-counter derivatives market in Hong Kong.

We have sought comments from all HKAB members and would like to enclose members' views in the appendix for your consideration. We hope that you would find the above comments helpful in developing the legislative framework and detailed requirements for regulating the over-the-counter derivatives market.

For any questions, please contact

Yours sincerely

Enc.

cc: Chief Executive Officer, Securities and Futures Commission

Chairman Bank of China (Hong Kong) Ltd
Vice Chairmen The Hongkong and Shanghai Banking Corporation Ltd
Standard Chartered Bank (Hong Kong) Ltd

主席 中國銀行（香港）有限公司
副主席 香港上海匯豐銀行有限公司
渣打銀行（香港）有限公司

**Hong Kong Monetary Authority and Securities and Futures Commission
Proposed regulatory regime for the over-the-counter derivatives
market in Hong Kong**

Submission of The Hong Kong Association of Banks

30 November 2011

Introduction

This paper sets out the views of The Hong Kong Association of Banks (“**HKAB**”) in relation to the proposed Hong Kong regulatory regime for over-the-counter (“**OTC**”) derivatives, in the “Consultation paper on the proposed regulatory regime for the over-the-counter derivatives market in Hong Kong” (“**Consultation Paper**”) issued jointly by the Hong Kong Monetary Authority (“**HKMA**”) and the Securities and Futures Commission (“**SFC**”) on 17 October 2011.

Overall, HKAB understands the global and domestic drivers of OTC derivatives reform, and the need to create a system that appropriately navigates Hong Kong’s position in the international market and its local regulatory framework and industry needs. In this regard, HKAB supports a clearing and reporting regime that appropriately mutualises risk, and which is transparent, efficient and congruent with international standards.

Assisted by Malesons Stephen Jaques, we have examined the Consultation Paper in detail and identified the areas of concern that we wish to raise with the HKMA and the SFC at this stage. These are set out sequentially, in response to Questions 1 to 14 of the Consultation Paper. Where appropriate, each section (corresponding to the Consultation Paper) also contains an executive summary of the key points raised, to facilitate your review.

We emphasise that the views expressed in this consultation response are preliminary only, in light of the high-level nature of the Consultation Paper. Additional detail is required for HKAB members to assess the full impact of the new regime on their organisations. Secondly, fundamental legal issues relating to insolvency, capital and netting will need to be addressed in due course. In this respect, HKAB looks forward to providing comprehensive comments on the proposals when they are released in 2012.

We look forward to an ongoing dialogue with the HKMA and the SFC in relation to the proposed OTC derivatives regime. We also look forward to reviewing the consultation conclusions that are published in due course.

Terms that are defined in the Consultation Paper have the same meaning when used in our response.

HKAB’s response

A The broad framework

In summary, HKAB:

- (a) *supports a proposed ‘tiered’ approach to the new regime, but believes that to ensure market certainty, the primary legislation must contain the essential elements of that regime and the subsidiary legislation should be restricted to dealing with matters that are genuinely second-level operational details (see paragraph 1.1);*
- (b) *suggests that the foundation for the new concept of “OTC derivatives transaction” should be the term “derivative contract” used in the Banking (Capital) Rules (Cap. 155L) (“Banking Capital Rules”), with necessary adjustments, rather than the term “structured products” used in the SFO (see paragraph 1.2); and*

- (c) *welcomes the continuing regulation of AIs by the HKMA, but urges the regulators to adopt a consistent approach to the ongoing regulation of the OTC derivatives market (see paragraphs 2.1 and 2.2).*

Q1 Do you have any comments on the proposed scope of the regulatory regime for the OTC derivatives market in Hong Kong and how it is proposed to be set out?

1.1 Structure of the new regulatory regime

HKAB supports the proposed 'tiered' approach to the new OTC derivatives regulatory regime, whereby the Securities and Futures Ordinance (Cap. 571) ("SFO") contains the high-level requirements and subsidiary legislation provides additional details. In particular, we recognise that the use of subsidiary legislation provides greater flexibility for future development.

However, we suggest that a clear distinction needs to be drawn between:

- (a) second-level operational detail on the one hand, which justifiably needs to be in subsidiary legislation; and
- (b) essential elements of the new regime, including threshold definitions, concepts and requirements, which we believe must be housed in the primary legislation for the benefit of providing certainty to market participants.

We therefore ask that the "details of the scope of [the mandatory reporting, clearing and trading requirements] and related matters"¹ that are proposed to be included in subsidiary legislation be restricted to genuinely second-level operational details.

1.2 Definition of "OTC derivatives transactions"

In principle, HKAB supports the use of a definition that aligns with concepts that are used in existing legislation, to maximise consistency in regulation and avoid duplication and confusion. We also support the proposed exclusions set out in paragraph 38 of the Consultation Paper,² which we believe recognise the nature of OTC derivatives transactions and existing regulatory structures.

We also recognise that "OTC derivatives transactions" is generally intended to serve only as a broad umbrella term, and that the mandatory clearing and reporting requirements will only attach to products that are specifically designated for that purpose in subsidiary legislation. That being said, we are equally conscious that the term is proposed to be used to define who needs to be licensed for the proposed new Type 11 regulated activity. We also strongly believe that the term should accurately reflect what the industry has long understood to be a "derivative".

As a result, HKAB suggests that the definition of "structured products"³ is a problematic one to use as the foundation to define "OTC derivatives transactions". Specifically, we do not believe that instruments with embedded derivatives (that is, compound products such as structured notes) are appropriately categorised as OTC derivatives.

In this respect, the regulatory regime for structured products should be distinguished from this proposal. In particular, we suggest that:

- (a) the structured products regime was designed to cast a very broad "wrapper neutral" net across a very broad range of products - not just OTC derivatives;
- (b) structured products (in the general sense, meaning compound instruments) *contain* embedded derivatives - they are not necessarily derivatives themselves.

¹ Paragraph 26, Consultation Paper.

² Paragraph 41(3), Consultation Paper.

³ In Part 1A of Schedule 1 to the SFO, as suggested in paragraph 38 of the Consultation Paper.

Such products are therefore not conceived by the market as OTC derivatives, and should not be regulated as such; and

- (c) a CCP would not be able to clear a structured (compound) product in the same sense as clearing an OTC derivatives transaction.

We suggest that paragraph (a) of the definition of “derivative contract” in section 2 of the Banking Capital Rules would therefore serve as a more appropriate base, with appropriate amendments to capture the proposed exclusions. That paragraph reads as follows:

“(a) ...a financial instrument (other than a bond, loan, share, note or structured financial instrument) the value of which is determined by reference to the value of, or any fluctuation in the value of, one or more than one underlying asset, index, financial instrument, rate or thing as designated in the financial instrument”.

This definition can also be supplemented by additional terms used in the Banking Capital Rules, such as “forward contract”, “option contract” and “swap contract”, with necessary adjustments. Please also refer to our comments in paragraph 3.3 in relation to the power to designate new products as “OTC derivatives transactions”.

Q2 Do you have any comments on the proposed division of regulatory responsibility between the HKMA and SFC?

2.1 Supervision of AIs

HKAB welcomes the proposal that AIs will continue to be primarily regulated by the HKMA in respect of the new OTC derivatives regime. Specifically, we believe that:

- (a) this is consistent with the supervision of AIs generally;
- (b) the HKMA is experienced in supervising AIs and issues relating to multi-jurisdictional regulation (particularly, AIs incorporated overseas) and dealing with offshore home regulators; and
- (c) this approach is important in the context of the upcoming Basel III reforms, which we understand will tie into clearing and will apply only to AIs.

2.2 Consistency is crucial

We understand that the regulation of AIs and other regulated persons is intended to be consistent in relation to derivatives clearing and reporting, because (as paragraph 35 of the Consultation Paper suggests) the subsidiary legislation will apply to both AIs and non-AIs. We support that approach and also agree to the proposal in that paragraph that the HKMA must first consent to any subsidiary legislation.

However, HKAB does have concerns about the risks of market participant-based (not product-based) regulation. In particular, there is an evident risk of regulatory arbitrage if the SFC and the HKMA adopt different rules or (in practice) interpret the new requirements differently. We wish to avoid a situation where one type of market participant has an advantage over others, unless that advantage arises because of differentiation that is deliberate and justified in all the circumstances.

We therefore urge the regulators to adopt a consistent approach to the ongoing regulation of the OTC derivatives market.

B Mandatory obligations and the products to be covered

In summary, HKAB:

- (a) supports a phased approach, whereby products to be cleared and/or reported are specifically designated, following market consultation (see paragraph 3.1);
- (b) emphasises the need for caution in relation to CCP-driven expansion of product coverage through a "bottom up" approach, given that CCPs have a commercial incentive to expand their services (see paragraph 3.2);
- (c) asks that the HKMA and the SFC issue a (publicly-available) policy framework that describes the circumstances in which new products are caught within the new regime (see paragraph 3.3); and
- (d) supports the exclusion of foreign exchange derivatives (other than NDFs) and equity derivatives at this time, asks for caution in relation to equity derivatives and requests further details of how Hong Kong regulators will interpret the concept of "standardised" OTC derivatives transactions (see paragraphs 4.1 and 4.2).

Q3 Do you have any comments on the proposal to take a phased approach to extending any mandatory reporting and clearing obligations?

HKAB understands the importance of taking a careful phased approach to the mandatory reporting and clearing obligations adopted in Hong Kong. We have the following comments in relation to the implementation of that approach.

3.1 The 'opt-in' approach should be adopted, with industry input

We fully support the proposal that only products specifically designated in subsidiary legislation will be subject to mandatory clearing and/or reporting.⁴

This 'opt-in' approach is essential to ensure that products are appropriately reviewed to verify, for example, that they are of sufficient standardisation and liquidity in order to support robust clearing operations. That approach is also important to ensure that products are clearly and appropriately defined before being caught as "reportable transactions" or "clearing eligible transactions", and that differences of opinion are resolved.

In that respect, we recommend that the need for market consultation (to which the Consultation Paper refers)⁵ be enshrined in the new regulatory framework. That is, HKAB asks that mechanics be included in the primary legislation that support industry input on proposed product inclusions.

3.2 Bottom up vs top down approach

The Consultation Paper indicates that:

"the HKMA and the SFC propose to adopt a top down and bottom up approach [to determining what are "clearing eligible transactions"], i.e. taking into consideration what regulators consider as products suitable for central clearing as well as products proposed by designated CCPs for central clearing."⁶

HKAB suggests that the future expansion of clearing eligible products using a 'bottom-up approach' should be approached with caution. Specifically, CCPs are naturally motivated

⁴ Paragraph 42, Consultation Paper.

⁵ Paragraph 58, Consultation Paper.

⁶ Paragraph 60, Consultation Paper.

to develop product clearing capability to enhance their competitive advantage. This should only drive regulatory reform if it is appropriate in all the circumstances.

We therefore emphasise the need for a careful review of any new product by the SFC and the HKMA, based on considerations of risk, international practice, domestic relevance, standardisation and liquidity; and importantly, appropriate consultation with industry stakeholders (see paragraph 3.1). Accordingly, we suggest that the new regime conceptualise the "bottom up" approach in more stringent terms.⁷

3.3 New product designation

HKAB asks that the HKMA and the SFC issue a policy framework that describes the circumstances in which:

- (a) a specific product might be designated as an "OTC derivatives transaction" (or be excluded from that definition), pursuant to the power described in paragraph 39 of the Consultation Paper; and
- (b) an OTC derivatives transaction would be designated as a "reportable transaction" and/or "clearing eligible transaction", pursuant to the process described in paragraph 58 of the Consultation Paper.

This type of framework would greatly assist the financial services industry to anticipate future developments that may affect its participants. We suggest that it would also facilitate transparent and consistent decision-making. This request is also linked to our comments about product expansion more generally in paragraphs 3.1, 3.2 and 4.2.

Q4 Do you have any comments on the proposal to initially limit the scope of any mandatory reporting and clearing obligations so that they apply in respect of certain IRS and NDF?

4.1 Proposed initial product scope

HKAB does not have any comments in relation to the initial products proposed in paragraph 59 of the Consultation Paper, at this stage.

4.2 Other products

HKAB supports the proposed exclusion of foreign exchange derivatives (other than NDFs) and equity derivatives from the first phase.⁸ In particular, these reflect a relatively small proportion of the market, and they lack the standardisation and liquidity necessary for central clearing.⁹

For the same reason, we ask that equity derivatives only be included in the next phase of regulatory development (as proposed)¹⁰ if they reach an adequate level of standardisation and liquidity. Even then, we suggest that only "plain vanilla" equity derivatives will ultimately be capable of effective clearing and reporting.

As a more general comment, we wish to understand the intended scope of "standardised OTC derivatives transactions" - that is, how Hong Kong regulators propose to interpret the

⁷ For example, the Australian Council of Financial Regulators described it in the following terms in a recent discussion paper on similar reforms in that country, which suggest stronger regulatory oversight (through licensing) and industry input: *"The bottom-up approach, in contrast, allows for a more industry-led process, where authorities can designate a set of products as mandatorily clearable if and when a CCP has requested and been granted a licence to clear those products."* paragraph 1.3.1, "Central Clearing of OTC Derivatives in Australia: A discussion paper issued by the Council of Financial Regulators", June 2011 ("**Australian OTC Derivatives Proposal**").

⁸ Paragraph 54, Consultation Paper.

⁹ See, for example, the summary of data contained in the Technical Committee of the International Organization of Securities Commissions, "Reporting on Trading of OTC Derivatives", February 2011.

¹⁰ Paragraph 56, Consultation Paper.

issue of standardisation when considering which products should be cleared and/or reported. Please also refer to our comments in paragraph 3.3.

C Proposed mandatory reporting obligation

In summary, HKAB:

- (a) *strongly objects to the proposal for Hong Kong reporting obligations to extend to transactions that LCs and AIs have "originated or executed", but to which they are not a counterparty (see paragraph 5.1);*
- (b) *welcomes the use of objectively ascertainable criteria to define the term, "Hong Kong nexus", rather than qualitative factors that have been proposed by certain other jurisdictions (see paragraph 5.2);*
- (c) *believes that the scope of persons proposed to be caught as "Hong Kong persons" is too broad, and is likely to cause difficulties in interpretation (see paragraph 5.3);*
- (d) *advocates for the recognition and use of global TRs. To the extent that this cannot be accommodated as part of the initial phase, we support the adoption of international standards in relation to the information required to be provided to the HKMA-TR and that the HKMA-TR be developed with the infrastructure capability to handle automated information inflows from electronic confirmation platforms (see paragraph 5.4);*
- (e) *disagrees with the proposal to require locally-incorporated AIs to report the positions of their subsidiaries for the purposes of consolidated supervision (see paragraph 5.5); and*
- (f) *has a small number of additional implementation concerns, which are described in paragraph 5.6.*

Q5 Do you have any comments on the proposed mandatory reporting obligation, and how it will apply to different persons?

5.1 "Originated or executed"

HKAB strongly objects to the proposal for the mandatory reporting obligation to extend to transactions that LCs and AIs have "originated or executed", but to which they are not a counterparty.¹¹

We do not dispute the observation¹² that Hong Kong provides origination and execution services to its branches and affiliates in other jurisdictions. However, we disagree that this is unique to the Hong Kong market, or that it justifies a reporting obligation.

Our reasons are as follows:

- (a) **Unworkable in practice** - The Consultation Paper defines the term "originated or executed" by reference to a person having negotiated, arranged, confirmed or committed to a transaction.¹³ The difficulties with this are three-fold:
 - (i) first, this covers an exceptionally broad range of activities, of uncertain scope;
 - (ii) secondly, these activities can be very difficult to track, particularly where the degree of involvement is low. We suggest that it is not possible to clearly define an acceptable threshold level of involvement that is workable across the financial services industry and provides a

¹¹ Paragraphs 61(1) and (2), Consultation Paper.

¹² Paragraphs 65 and 66, Consultation Paper.

¹³ Paragraph 64, Consultation Paper.

sufficiently consistent standard for both internal monitoring and TR reporting purposes; and

- (iii) thirdly, the fact that the person originating or executing the transaction is not a counterparty to it suggests that there are at least two other parties who may be subject to reporting requirements. We believe that mandatory reporting in Hong Kong therefore offers minimal value (see paragraph 5.1(b)).
- (b) **Transaction likely to be regulated elsewhere** - The offshore entity to which a transaction is booked (or its counterparty) is likely to be subject to a mandatory reporting obligation in its own jurisdiction. Paragraph 84 of the Consultation Paper expressly recognises this, and goes on to acknowledge that:

"[r]egulators in different jurisdictions are working towards putting place information sharing arrangements whereby information collected through TRs in their own jurisdiction will be shared with overseas regulators. This will enable regulators to better identify and manage risks relating to their own markets".

We therefore reiterate that mandatory reporting in Hong Kong offers minimal value, particularly when weighed against the significant compliance challenges and costs involved, and the likelihood of overlapping regulation.

- (c) **Not supported by international practice** - Detailed proposals are gradually emerging from other jurisdictions. So far, we note that:
 - (i) the reporting obligations under the latest European proposals¹⁴ attach to counterparties - not others who might assist in the transaction process; and
 - (ii) similarly, Australian regulators have proposed that the "Australian OTC derivatives market" should be defined by reference to the counterparties with which transactions are booked,¹⁵ which recognises that the focus of the regulatory regime should be to address systemic risk, not market conduct or market control.
- (d) **Disproportionate impact** - This requirement is particularly onerous for overseas-incorporated AIs. We do not believe that the compliance burden is adequately alleviated by the proposal in paragraph 67 of the Consultation Paper, because this still ultimately requires reporting to the HKMA-TR.

The problems associated with this concept are heightened in the context of mandatory clearing. Please refer to our comments in paragraph 8.1.

5.2 "Hong Kong nexus"

We understand that a "Hong Kong nexus" is required before a transaction to which an overseas-incorporated AI is a counterparty (through an offshore branch) is caught by the mandatory reporting requirement.¹⁶ We strongly recommend that the definition of this term contain (as is currently proposed)¹⁷ objectively ascertainable criteria that can be discerned from key transaction details. It should not, as has been proposed in other

¹⁴ Article 6, "Proposal for a regulation of the European Parliament and of the Council on OTC derivative transactions, central counterparties and trade - Presidency Compromise" dated 23 September 2011 ("EU OTC Derivatives Regulation"). Similarly, Article 3 (relating to clearing) also focuses on counterparties.

¹⁵ Paragraph 4.3, Australian OTC Derivatives Proposal. We note that these statements were made in the context of a discussion on clearing requirements, but we take them as indicative of the approach on reporting, given their generality.

¹⁶ Paragraph 61(2), Consultation Paper.

¹⁷ Paragraph 71, Consultation Paper.

jurisdictions, extend to qualitative factors such as the potential impact on the financial and monetary stability of the jurisdiction.

5.3 “Hong Kong persons”

HKAB believes that the scope of persons proposed to be caught as “Hong Kong persons”¹⁸ is too broad. In particular:

- (a) we ask that references to terms such as “based in”, “operated from”¹⁹ and “managed in or from”²⁰ be avoided, because:
 - (i) these terms are subjective in nature and difficult to ascertain in practice. This undermines the principle of legislative certainty and increases legal and compliance costs; and
 - (ii) their use will result in overlapping and inconsistent regulation, given that these persons are not, in our view, genuinely Hong Kong persons and are likely to be regulated elsewhere; and
- (b) we suggest that the definition of “Hong Kong persons” use objectively ascertainable standards that draw upon existing statutory definitions and requirements, such as registration under the Business Registration Ordinance (Cap. 310) and incorporation and registration under the Companies Ordinance (Cap. 32).

5.4 Global vs local reporting

HKAB is strongly in favour of the recognition and use of global TRs. These provide a tremendously useful service to market participants and regulators alike, with substantial operational advantages. We suggest that existing global TRs (such as the Depository Trust & Clearing Corporation TR) demonstrated their value during the recent Lehman Brothers crisis.

We believe that global TRs are especially important because reporting requirements in G20 and other jurisdictions are highly likely to overlap, by virtue of the extra-territorial reach of their regulatory requirements, and the cross-border nature of financial transactions. The mandatory use of a local TR (as is proposed for Hong Kong)²¹ inevitably results in multiple reporting according to differing standards. This increases costs, poses infrastructure challenges, places pressure on other resources, can cause overseas legal and regulatory problems (see paragraph 5.6(b)) and increases the likelihood of data inconsistencies.

However, we recognise that there are currently justified concerns about the use of global TRs. These include ensuring that local regulators have access to data when they need it, and that data is collected and aggregated in a way that is meaningful to individual jurisdictions. To the extent that these (and other) issues cannot be resolved before the implementation of the Hong Kong OTC derivatives reporting regime, we ask that:

- (a) international standards be adopted in relation to the information required to be provided to the HKMA-TR, to ensure consistency and keep costs to a minimum. In this respect, we welcome the comments made in paragraph 50 of the Consultation, and by the HKMA in its November 2011 consultation report, to this effect;²²

¹⁸ Paragraphs 77 to 78, Consultation Paper.

¹⁹ Paragraph 77(2), Consultation Paper.

²⁰ Paragraph 77(4), Consultation Paper.

²¹ Paragraph 61, Consultation Paper.

²² Paragraphs 29 to 33, “Report on consultation on logistical and technical arrangements for reporting to Hong Kong trade repository” issued by the HKMA on 8 November 2011.

- (b) the HKMA-TR be developed with the infrastructure capability to handle automated information inflows from electronic confirmation platforms; and
- (c) Hong Kong regulators support the development of an appropriate global TR framework and, in the meantime, consider delaying the implementation of reporting requirement for offshore transactions.

This is particularly important for locally-incorporated AIs, which will be subject to the most extensive reporting obligations and many of which have a significant number of overseas branches and subsidiaries. In this respect, please refer to our comments in the following paragraph 5.5.

5.5 Reporting for the purposes of consolidated supervision

HKAB disagrees with the proposal to require locally-incorporated AIs to report the positions of their subsidiaries²³ for several reasons, including the following:

- (a) First, certain subsidiaries will already have independent reporting obligations in Hong Kong: for example, by virtue of being an LC. In such cases, further reporting is duplicative and, in our view, unnecessary.
- (b) Secondly, we suggest that the HKMA will have a sufficiently clear picture of the position of a locally-incorporated AI based on the information required to be reported under the new OTC derivatives regime, coupled with existing reporting requirements.
- (c) Thirdly, there are numerous legitimate reasons for which an entity may be reluctant to disclose trading information (which may include client information) to other group entities, such a locally-incorporated AI. These include duties and expectations of client confidentiality, local privacy laws and regulatory requirements and practical considerations such as information technology, data security, human resources and cost.

To the extent that the HKMA chooses to mandate any kind of reporting in relation to subsidiaries, we strongly suggest that:

- (i) a distinction be drawn between subsidiaries that are (100 per cent.) wholly-owned by the locally-incorporated AI, and those that are not. The latter should not be included in any reporting obligation; and
- (ii) appropriate exemptions be made for circumstances that make reporting difficult or impossible, including those described in paragraph 5.5(c).

5.6 Additional implementation issues

HKAB has the following additional implementation comments and queries in relation to the proposed reporting requirements:

- (a) **Reporting on a group basis** - First, in relation to locally-incorporated AIs, we would like to clarify whether group reporting (if required) will satisfy the individual reporting requirements to which an entity might otherwise be subject, or whether it operates as an additional requirement. For example, if a subsidiary has 20 reportable transactions and its group has 50 reportable transactions, should the subsidiary report its 20 transactions on an entity level and the group report a total of 70 transactions to the HKMA-TR on a consolidated basis, or is the group report sufficient?
- (b) **Client confidentiality and other host country obstacles** - Secondly, overseas regulators may impose client confidentiality and bank secrecy obligations that

²³ Paragraphs 61(1) and 69(2), Consultation Paper.

cannot be overcome by Hong Kong statutory requirements (even if coupled with client consent). Consequently, there is no assurance that client-related data required to be reported to the HKMA-TR can in fact be reported without risking substantial penalties. Other applicable home or host country obligations may also make reporting impossible or very onerous - for example, certain reporting activities may be interpreted by host regulators as offshoring, which can be problematic. We ask that the Hong Kong regulatory regime expressly contemplate these types of situations.

- (c) **Approach to data collection** - Thirdly, AIs' derivatives activities are already subject to the HKMA's oversight. This emphasises the need for an efficient and effective approach to data collection under the proposed OTC derivatives reporting regime, to manage the risks of information overload and to minimise potential reconciliation issues and discrepancies.
- (d) **Agents** - Fourthly, HKAB welcomes confirmation that reporting to the HKMA-TR can be effected through an agent.²⁴ We ask, however, that appropriate protections be adopted for institutions that use reporting agents, to ensure that such institutions are only liable for breaches of the Hong Kong reporting rules attributable to their own actions, rather than by way of strict liability.

Q6 Do you have any comments on the proposal to adopt a specified reporting threshold for persons other than AIs and LCs, and how the threshold will apply?

HKAB has no comments on this proposal, at this stage. However, we welcome indicative guidance as soon as practicable on what the "specified reporting threshold" is likely to be, to facilitate planning.

Q7 Do you have any comments on the proposed grace periods and how they will apply?

7.1 More time is required for implementation

HKAB fully supports the proposal that the grace periods only commence when the mandatory reporting obligation comes into effect,²⁵ when persons first become subject to that obligation²⁶ or when the obligation extends to a new product type.²⁷

However, we ask that more time be allocated to implementation after the proposals have been finalised. For example, members are concerned about the time required to modify their internal systems to extract the required data for reporting, and to address issues relating to data that is not electronically available. Further, the trading and back office systems of most overseas incorporated AIs are developed and maintained centrally overseas (eg in the home country), and back office processing may also be conducted offshore (often, in neither the home country nor Hong Kong).

More time should therefore be provided to AIs to deal with practical difficulties, coordinate with relevant stakeholders and develop solutions. We suggest a period of at least six months would be appropriate.

²⁴ Paragraph 107(6), Consultation Paper.

²⁵ Paragraph 103, Consultation Paper.

²⁶ Paragraph 104, Consultation Paper.

²⁷ Paragraph 105, Consultation Paper.

D Proposed mandatory clearing obligation

In summary, HKAB:

- (a) *echoes its strong concerns about reporting "originated or executed" transactions, now in relation to the proposed mandatory clearing obligation. We believe that the issues are even greater in this context (see paragraph 8.1);*
- (b) *asks that intra-group transactions be exempted, in line with recent international developments and with appropriate protections (see paragraph 8.2);*
- (c) *requests that the proposed OTC derivatives clearing framework provides guidance on circumstances in which clearing obligations in different jurisdictions conflict (see paragraph 8.3);*
- (d) *also wishes to raise a handful of comments relating to insolvency, margin arrangements, de-clearing and trade compression and default management (see paragraph 8.4);*
- (e) *supports the proposal to apply a specified clearing threshold to all persons, but has concerns about the potential liability implications for HKAB members (see paragraphs 9.1 and 9.2). We also ask for appropriate relief for commercial end users that use derivatives to hedge against price volatility and to mitigate commercial risks (see paragraph 9.3); and*
- (f) *asks for a longer grace period for implementation, as described in our response to Question 10.*

Q8 Do you have any comments on the proposed mandatory clearing obligation, and how it will apply to different persons?

8.1 "Originated and executed"

HKAB strongly objects to the proposal for the mandatory clearing obligation to extend to transactions that LCs and AIs have "originated or executed", but to which they are not a counterparty.²⁸

Our reasons for objecting to this in the context of mandatory reporting obligations are set out in paragraph 5.1, and those reasons also largely apply to clearing. In particular, the proposal is unworkable in practice, increases the likelihood of overlapping regulation and is not supported by emerging international practice.

Realistically, an institution that is not a counterparty to a transaction has minimal power (if any) to compel the actual counterparties to clear that transaction through a designated CCP, or any CCP for that matter. For example, there may be differences of opinion as to whether those counterparties may be entitled to the proposed exemptions from clearing,²⁹ or whether the specified clearing threshold has been met. The proposals in relation to compliance responsibility³⁰ therefore create an alarming potential liability.

In the context of clearing, we are also especially concerned about overlapping regulation. This is because an OTC derivative transaction cannot be cleared multiple times. The need to contain the extra-territorial reach of the Hong Kong clearing obligations cannot therefore be overstated.

While we understand the need to control potential regulatory arbitrage, we urge the HKMA and the SFC to bear in mind the role of international standard setting bodies to monitor the implementation of the G20 clearing mandate globally. For example, the Financial Stability Board has made the following important recommendation:

²⁸ Paragraph 110(1)(a), Consultation Paper.

²⁹ Paragraph 110(2), Consultation Paper.

³⁰ Paragraph 132(2), Consultation Paper.

"To minimise the potential for regulatory arbitrage, IOSCO, working with other authorities as appropriate, should coordinate the application of central clearing requirements on a product and participant level, and any exemptions from them."³¹

We suggest that this implies that gaps in regulation should be addressed through cooperation between jurisdictions and appropriately tailored solutions - not with nets cast widely by each jurisdiction.

We recognise that the Consultation Paper foreshadows the recognition of offshore CCPs as "designated CCPs" for the purpose of Hong Kong clearing obligations.³² However, we suggest that this does not provide an adequate solution. First of all, we expect that recognition of offshore CCPs will take time. Secondly, it does not address the practical issues relating to identifying transactions that meet the "originated or executed" test, nor our objection to such transactions being caught by Hong Kong regulation as matter of principle.

8.2 Intra-group transactions

HKAB asks that the Hong Kong clearing obligation include an exemption for intra-group transactions, with appropriate protections, in line with European proposals.³³

As the Financial Stability Board observed recently:

"Intra-group [OTC derivatives] transactions may be used for may be used for centralised group risk management. Proposed EU legislation envisages that [certain] derivatives transactions...would be exempt from the central clearing obligation. This is because requiring clearing of intra-group transactions could substantially increase the capital and liquidity required by firms that centralise risk management in certain entities as well as increase operational complexity."³⁴

We also note the comments made by Hong Kong in connection with that report, to the effect that it will "keep in view global developments in this regard".³⁵ Given the developments that have occurred, we encourage the HKMA and the SFC to consider including this exemption.

8.3 Resolving conflicting clearing requirements

Linked with our general concerns about overlapping regulation, we ask that the Hong Kong clearing requirements provide a mechanism to resolve conflicting clearing obligations.

8.4 Additional comments

Finally, HKAB members have the following additional comments in relation to mandatory clearing:

- (a) **Insolvency** - We believe that it is essential that both domestic and international insolvency issues be examined closely as part of the implementation of the proposed OTC derivatives framework. In addition to any local legislative enhancements required, we ask the SFC and the HKMA to encourage designated CCPs to assess relevant overseas insolvency laws as part of the clearing membership application process, and in connection with collateral arrangements.

³¹ Recommendation 12, "Implementing OTC Derivatives Market Reforms", 25 October 2010.

³² Paragraphs 145 and 147, Consultation Paper.

³³ See Articles 2a and 3(1)(a), EU OTC Derivatives Regulation.

³⁴ "OTC Derivatives Market Reforms - Progress report on Implementation", 11 October 2011 ("FSB October 2011 Report"), page 16.

³⁵ Table 6, FSB October 2011 Report.

- (b) **Margin arrangements** - HKAB wishes to understand the proposed approach to margin at the CCP and client levels. In particular, how flexible the Hong Kong regulatory regime will be in relation to the degree of segregation (for example, if it will enable clients to post collateral directly with the CCP, and for participants to choose between omnibus and segregated accounts), how it will address the need for portability, which assets will qualify, calculation standards, netting, etc. We also look forward to receiving details of other clearing-related arrangements, including the framework for settlement charges and illiquid asset price handling (if any).
- (c) **De-clearing and trade compression** - We suggest that the new framework expressly provide for de-clearing and trade compression, to ensure that transactions can be removed from the CCP.
- (d) **Default management** - We also support appropriate SFC and HKMA oversight and guidance on default management structures adopted by designated CCPs (see further our comments in paragraph 12.4). We also hope to receive further details of the overarching default waterfall rules, as well as the specific arrangements proposed by HKEx as soon as possible.

Q9 Do you have any comments on the proposal to adopt a specified clearing threshold, and how the threshold will apply?

9.1 Adoption of threshold and industry input

Overall, HKAB supports the proposal to apply a specified clearing threshold to all persons to limit the scope of the clearing obligation and keep transaction costs to a minimum.³⁶ We would also welcome the opportunity to provide industry input into the determination process described in paragraphs 120 and 121 of the Consultation Paper.

9.2 Lack of transparency in relation to counterparties

We understand that the proposed specified clearing threshold will be determined by reference to the average notional value of a person's month-end positions for the preceding six-months.³⁷ Given that the threshold applies to both counterparties, HKAB members are concerned that they will not be in a position to know if their counterparties have exceeded the specified clearing threshold and, therefore, whether or not a particular trade is a "clearing eligible transaction".

This has important ramifications in relation to compliance responsibility³⁸ and we ask for additional guidance on this issue (in particular, possible sources of information that could be relied upon to verify whether the threshold has been exceeded), and appropriate protections from liability. This issue is particularly problematic for persons who have only "originated or executed" the transaction.

9.3 End users

HKAB asks for appropriate relief for commercial end users that use derivatives to hedge against price volatility and to mitigate commercial risks, rather than for speculative purposes. This is critical to ensure that hedging remains cost-effective.

We suggest that a suitable way to achieve this is to differentiate between the ways in which OTC derivatives are used by end users when calculating the specified threshold for clearing. In effect, this means that the specified threshold will not be so easily breached if the commercial end user primarily uses OTC derivatives for risk reduction purposes.

³⁶ Paragraphs 110(1)(b) and 117, Consultation Paper.

³⁷ Paragraph 122, Consultation Paper.

³⁸ As proposed in paragraphs 131 and 132 of the Consultation Paper.

We understand that this approach has been proposed in Europe, where it was observed that:

"...in determining whether a non-financial counterparty should be subject to the clearing obligation, consideration should be given to the purpose for which that non-financial counterparty uses OTC derivatives... When determining whether a non-financial counterparty has breached the threshold for clearing, it is recognised that OTC derivative transactions, which are objectively measurable as reducing risks directly related to the commercial activity or treasury financing activity of the counterparty or of the group, shall not count towards the clearing threshold."³⁹

If this proposal is adopted, HKAB would also appreciate guidance on how end-users (and indeed other relevant parties) can objectively ascertain the purpose of transactions when calculating the specified threshold for clearing. This also ties into our comment in paragraph 9.2 about compliance responsibility.

Q10 Do you have any comments on the proposed grace periods and how they will apply?

We ask for a longer initial grace period, of at least six months, to enable proper implementation of the proposed mandatory clearing obligations.

E Mandatory trading obligation

Q11 Do you have any comments on the proposal not to impose a mandatory trading obligation at the outset?

HKAB believes that a mandatory electronic trading obligation for OTC derivatives is not appropriate and should not be imposed in Hong Kong. We suggest that the current approach, which allows market participants to select appropriate circumstances in which to trade through an electronic platform, works well.

F Penalties for breaching mandatory reporting and clearing obligations

HKAB agrees with the proposal that the penalty regime should be on par with international practice and be limited to civil or administrative fines. We strongly believe that it should not extend to criminal liability.

G Designation and regulation of CCPs

In summary, HKAB:

- (a) *believes that CCPs must be subject to stringent regulatory principles, based on international standards, and ongoing oversight. The regulatory principles should cover (among other things) governance structures, effective risk management, default management and procedures, membership criteria and collateral management rules (including segregation and portability options) (see paragraphs 12.1 to 12.6); and*
- (b) *recommends that offshore CCPs that meet the requisite criteria be permitted to offer clearing services in Hong Kong, and that the new regime address issues relating to "closed market jurisdictions" that mandate onshore clearing (see paragraph 12.7).*

³⁹ Paragraph 16, EU OTC Derivatives Regulation (preamble). See also paragraph 16a, which elaborates upon the concept of "risks directly related to the commercial activity", and the substantive and empowering provisions in Articles 5(3) and (4) of the EU OTC Derivatives Regulation.

Q12	Do you have any comments on any aspect of our proposals for the designation and regulation of CCPs?
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12.1 A robust CCP regulatory framework is essential

Mandatory clearing through a CCP redistributes and naturally concentrates counterparty risk in relation to OTC derivatives transactions.

As a result, HKAB believes that designated CCPs must be subject to stringent regulatory principles based on international standards,⁴⁰ as well as ongoing oversight. In this respect, HKAB recognises that the SFC has a wide discretion in relation to approving, and imposing conditions on, RCHs and authorised ATS providers.

The following paragraphs describe some of the areas of particular concern, although they are by no means exhaustive.

12.2 Governance structure

We suggest that when CCPs are part of trading platforms or settlement systems, there is a potential to create conflicts of interest and expose the CCPs to risks unrelated to their clearing operations. One way to mitigate these conflicts and protect CCPs from contagion risk is to legally ring-fence the CCP operations from the other activities and to have governance structures incorporating independent directors. When designing the governance structure, we believe that CCP risk management functions should report directly to the top organisational level (for example, the board of directors) and be separated from the management of financial resources. The interests of the clearing member's clients - such as through an advisory role in the corporate structure or as independent directors - should also be taken into account.

The European Commission has provided provisions to ensure the "safety, soundness and proper governance" of CCPs, including:

- (a) robust governance arrangements;
- (b) a requirement to have an internal risk committee;
- (c) written organisational and administrative arrangements to identify and manage potential conflicts of interest;
- (d) principles that ensure that a CCP remains fully responsible for the discharge of any operational function or services or activities that it outsources;
- (e) participation requirements to ensure non-discriminatory, fair and open access to a CCP and other additional requirements such as ensuring that clearing members have sufficient financial resources;
- (f) obligations to disclose prices and fees associated with services provided (imposed also on clearing members);
- (g) principles governing segregation of assets and positions within CCPs and its clearing members; and
- (h) prudential requirements, including an initial capital requirement, margin requirements, default procedures, a default fund and a default waterfall, reviews of models, stress testing and back testing.⁴¹

We also suggest that ownership rules should be considered carefully to minimise potential conflicts of interest.

⁴⁰ In particular, the CPSS-IOSCO consultative report, "Principles for Financial Market Infrastructures", March 2011.

⁴¹ See Title IV, EU OTC Derivatives Regulation.

12.3 Effective risk management

Managing risk efficiently is central to the success of designated CCPs and the stability of the Hong Kong OTC derivatives market.

Critical issues to address are as follows:

- (a) **Systemic risk** - Counterparty concentration risk will arise from the CCP facing all trades and becoming a 'systemically important financial entity'. The margin and collateral structure must be robust.
- (b) **Liquidity risk** - Managing adverse market conditions and creating the right model for a "backstop" in case of a liquidity crisis. Considering the liquidity of new products to be cleared through the CCP, liquidity lines should match the product currency. Rules on access are required.
- (c) **Settlement risk** - Risk concentration in a small pool of settlement banks - linked to liquidity risk, there is a need to consider emergency central bank liquidity options.
- (d) **Operational risks** - Integral to the rules of the CCP and the supporting statutory and regulatory framework. For example, trades should be captured at the time of execution (or as soon as possible after) to reduce intraday risks. Back-up infrastructures are required and key system components should be scalable to handle higher volumes during times of stress.
- (e) **Custody and investment risk** - Protecting the assets owned by the CCP and its participants, through robust custodial arrangements and investment policies, procedures and oversight.
- (f) **Clearing members** - Stringent requirements to become a clearing member, in terms of sufficient financial resources, robust operational capacity, and business expertise. These requirements should be clear, publicly disclosed, objectively determined, and commensurate with risks inherent in the cleared products and the obligations of the clearing member to the CCP. See further our comments in paragraph 12.5.
- (g) **Cost of providing margin and collateral** - Ensuring there are sufficient incentives for participants to comply and to balance the loss of certain netting advantages.
- (h) **Market perceptions: stability and cost-efficiency** - Making the CCP competitive in the international market and, in particular, relevant to key markets such as Mainland China.

12.4 Default management and procedures

Designated CCPs will constitute important Hong Kong financial market infrastructures. Common to these institutions is the need to address participant defaults and have a management group that oversees their operation and exercises any necessary discretion.

Participant default rules and procedures need to clearly (and publicly) identify:

- (a) what constitutes a participant default – this may be financial or operational;
- (b) the method used to identify a default, including whether the default occurs automatically or if some judgment or discretion needs to be exercised;
- (c) the options open to the CCP if a default occurs, and what the consequential effects are – for example, to margin or collateral requirements or to settlement or processing practices; and

- (d) the roles and responsibilities of various parties, including non-defaulting participants.

Given its systemic importance, the CCP should also be expected to:

- (i) have sufficient power and flexibility to take 'extraordinary emergency actions' during times of market stress and participant default;
- (ii) have a governance process that can deal with these situations;
- (iii) limit the economic impact of its emergency actions to keep the market balanced and rules operating as normally as possible; and
- (iv) contribute to the development of market conventions and standards (and comply with them).

In Europe, there are a number of prudential requirements to guard against default by CCPs. These include requirements to assess liquidity and credit exposures to each clearing member on a near-real-time basis⁴² and to ensure that exposures are fully collateralised with highly liquid collateral.⁴³

12.5 Membership criteria

CCP membership criteria requires a balance to be struck between (a) as wide a membership base as possible in order to encourage clearing volumes; and (b) the risk to the CCP arising from a clearing member default.

Rules governing access to CCPs by market participants vary across CCPs, in part reflecting the risk characteristics of the products they clear. CCPs that offer OTC derivatives generally have high membership standards because the products are more complex.

The criteria CCPs adopt for direct membership should be risk-focused, sufficient to protect the financial integrity of the CCP, and meet evolving international standards developed jointly by CPSS and IOSCO. For example, the current European proposals require CCPs to have non-discriminatory, transparent and objective criteria for admission of clearing members so as to ensure fair and open access to CCPs. However, those proposals recognise that unfettered access to a CCP could jeopardise its effective operation. Therefore, the CCP must ensure that clearing members have sufficient financial resources, operational capacity and membership criteria that restrict access "to the extent that their objective is to control risk for the CCP".⁴⁴ In addition, where clearing members wish to clear contracts on behalf of their clients, the European proposals also require additional financial resources and operational capacity.⁴⁵

12.6 Segregation and 'ring fencing'

Segregating and 'ring fencing' collateral is a topical issue. At the minimum, we believe that the prevailing view among financial industry stakeholders is that each participant's collateral should be readily identifiable, recoverable and portable.

However, HKAB is aware that there is demand from market participants for further protection. In particular, they advocate ring fencing, whereby each participant has their own account (not an entry in an omnibus account) and their collateral can only be used to cover their own default. This protects the collateral from exposure to other participants' defaults. Ring fencing can also include an option for grouping certain participants who are willing to pool their collateral. The downsides to ring fencing are (a) increased costs,

⁴² Article 38, EU OTC Derivatives Regulation.

⁴³ Article 48(1), EU OTC Derivatives Regulation.

⁴⁴ Article 35(1), EU OTC Derivatives Regulation.

⁴⁵ Article 35(3), EU OTC Derivatives Regulation.

imposed directly on the participant and/or borne by all participants through a larger default fund; and (b) higher operational needs for the CCP.

From a regulatory standpoint, we suggest that legal certainty is important. We are aware, for example, that the European proposals allow participants to choose different levels of segregation. We would welcome this kind of flexibility.

12.7 Offshore CCPs

Finally, HKAB supports the designation of offshore CCPs, provided that they are subject to the same stringent criteria and oversight as a local designated CCP. We believe that this provides an important degree of flexibility, particularly for overseas-incorporated AIs. In this respect, we believe that limiting the scope of designated CCPs to domestic entities would give rise to the very issues highlighted in paragraphs 147 and 149 of the Consultation Paper.

However, we also wish to raise the issue of offshore CCPs in "closed market jurisdictions". These are jurisdictions that require trades to be cleared onshore, whether for the purpose of foreign exchange control or to address other local regulatory concerns. It is possible that CCPs in such jurisdictions will not be in a position to meet the criteria applicable to local (Hong Kong) designated CCPs. This poses a significant dilemma where there is a parallel clearing obligation in Hong Kong.

We suggest that two options to address this are:

- (a) exempting such trades from the Hong Kong clearing requirements; or
- (b) creating a separate approval process for such "closed market" offshore CCPs. We suggest this process should be separate, to:
 - (i) maintain the integrity of general designation standards; and
 - (ii) be able to distinguish these types of CCPs from international standard-compliant CCPs, when it comes to calculating CCP exposures under future Basel III-related Banking Capital Rules.

This issue is important for both overseas-incorporated AIs and for AIs incorporated in Hong Kong (whose clearing and trading obligations may extend to overseas subsidiaries).

H Capital charges and margin requirements

12.8 General queries and concerns

HKAB has the following queries and concerns in connection with the high-level proposals in section H of the Consultation Paper:

- (a) The latest proposals of the Basel Committee on Banking Supervision ("**BCBS**") (issued on 2 November 2011)⁴⁶ suggest that trade exposures to a qualifying CCP will receive a low 2% risk weighting (or 0% if collateral is bankruptcy-protected),⁴⁷ and that there will be no capital charge on centrally cleared derivatives to address credit valuation adjustment risk (unlike bilateral trades).⁴⁸ We wish to confirm:

⁴⁶ BCBS, "Capitalisation of bank exposures to central counterparties - Consultative document" ("**BCBS CCP Paper**").

⁴⁷ Paragraphs 3, 19 and 20, BCBS CCP Paper.

⁴⁸ See paragraph 16, BCBS CCP Paper.

- (i) if the same approach will also be taken in Hong Kong;
 - (ii) how the proposed capital charge on bilateral transactions⁴⁹ will be determined, and how those transactions will be monitored; and
 - (iii) linked to sub-paragraph (ii), whether transactions that fall below the specified (monetary) clearing threshold will be caught. Given that capital costs may need to be passed on (at least in part) to end-users, we suggest that this approach could force some clients not to enter into a hedge solution because of the cost involved.
- (b) HKAB is also concerned that the proposed additional margin requirements imposed on transactions not cleared through a CCP⁵⁰ could result in double-counting. We would appreciate further details on how these margin requirements will be calculated.
- (c) We also wish to confirm:
- (i) how large exposures to a CCP will be treated, bearing in mind the naturally high concentration that will result from mandatory clearing obligations;
 - (ii) what capital charge will be imposed on contributions to a CCP default fund, bearing in mind BCBS' recent proposal;⁵¹ and
 - (iii) whether, and to what extent, non-Als will be subject to similar standards.

I Regulation of OTC derivatives market players (other than Als)

In summary, HKAB:

- (a) *fully supports the proposal for Als to be exempt from the proposed Type 11 licensing requirements, which is appropriate given Als' unique regulatory position (see paragraph 13.1);*
- (b) *has a small number of concerns about the definition of the new Type 11 regulated activity, including a suggestion that principal-to-principal trading with an institutional professional investor may require a licence, the potential scope of transactions caught, and the need to minimise overlap with existing licensing requirements (see paragraph 13.2); and*
- (c) *asks that the HKMA and the SFC promote rigorous CCP membership requirements (including appropriate financial resources, regulatory and operational capability standards), to complement the proposed Type 11 licensing regime for clearing agents (see paragraph 13.3).*

Q13 Do you have any comments on the proposed regulation of intermediaries in the OTC derivatives market?

13.1 Regulation of Als

HKAB fully supports the proposal for Als to be exempt from the proposed licensing requirements described in Section I of the Consultation Paper. In this respect, we echo the statements made by the SFC and the HKMA in paragraph 158(1) of the Consultation Paper, by emphasising that Als are subject to stringent regulatory controls and ongoing oversight by the HKMA. The proposed approach is therefore consistent with other

⁴⁹ That is, "OTC derivatives transactions that are not cleared through a CCP": paragraph 156 of the Consultation Paper.

⁵⁰ As suggested in paragraph 156 of the Consultation Paper.

⁵¹ See from paragraph 21, BCBS CCP Paper.

activities that are regulated in Hong Kong,⁵² which also recognise AIs' unique regulatory position.

13.2 Regulation of other derivatives market players

For HKAB members to fully assess the impact of the proposed regulation of other derivative market players on their organisations (which may include non-AI entities), it is necessary to see the detailed definition of the proposed Type 11 regulated activity and the scope of intermediaries and "large players" potentially caught.

In the interim, we wish to make the following preliminary comments:

- (a) **Exemptions** - HKAB welcomes the proposal to include exemptions similar to those contained in the definitions of other regulated activities.⁵³ However, we are concerned about the comment that adjustments may need to be made to reflect "that transactions in this market are typically conducted on a principal-to-principal basis".⁵⁴ This suggests that dealers trading with institutional professional investors⁵⁵ on a principal-to-principal basis may not be exempt. HKAB believes that this exemption for sophisticated trading relationships is important and should be adopted. We do not believe there is sufficient justification to differentiate derivatives dealing from securities / futures dealing.
- (b) **Scope of transactions caught** - Linked to our comments in paragraph 1.2, we are concerned that the proposed Type 11 regulated activity will effectively capture most "structured products".⁵⁶ This proposal erodes the significant progress made by the SFC and the financial services industry in 2009 and 2010 to ensure that only structured products that required SFC approval (or were already regulated) would be caught under the SFO licensing regime. This emphasises the need to narrow the scope of OTC derivatives transactions caught within the new definition.
- (c) **Dealing with overlaps** - We believe that to the maximum extent possible, the existing SFO licensing regime should remain intact, to minimise market disruption. Accordingly, we advocate for option (1) in paragraph 166 of the Consultation Paper.⁵⁷ We also suggest that appropriate exemptions for 'incidental' activities undertaken by existing LCs be adopted.

13.3 CCP membership rules

Last, we also request that the HKMA and SFC promote rigorous CCP membership requirements (including appropriate financial resources, regulatory and operational capability standards), to complement the proposed Type 11 licensing regime for clearing agents. We believe that a robust CCP, with high membership standards, is critical to the stability of the CCP during times of market stress and is ultimately in the interests of the Hong Kong financial industry as a whole. Please refer to our more specific comments in paragraph 12.5.

⁵² For example, Type 3 (leveraged foreign exchange trading) regulated activity under Schedule 5 to the SFO, lending services under the Money Lenders Ordinance (Cap. 163) and money changing activities under the Money Changers Ordinance (Cap. 34).

⁵³ As described in paragraph 162 of the Consultation Paper.

⁵⁴ Paragraph 162, Consultation Paper.

⁵⁵ That is, persons falling within paragraphs (a) to (i) of the definition of "professional investor" in Part 1 of Schedule 1 to the SFO.

⁵⁶ As defined in Part 1A of Schedule 1 to the SFO.

⁵⁷ That is, "to incorporate appropriate carve outs so that if a person's OTC derivatives activities are limited to activities that fall within the scope of an existing regulated activity, then he should be able to continue on the basis of his existing licence and not need to seek a licence for the proposed new Type 11 regulated activity" (option (1)), rather than "to amend the scope of the existing regulated activities so as to exclude any activities falling within the scope of the new Type 11 regulated activity" (option (2)).

Q14 Do you have any comments on the proposed regulatory oversight of large players?**14.1 Practical considerations - reporting**

HKAB appreciates the need to minimise the systemic risk posed by large trading positions and, therefore, the policy drivers for extending Hong Kong's regulatory oversight to large players in the OTC derivative market.

For now, members' primary concern (as AIs) is how reporting by large players will be effected in practice. Many of the large players canvassed by the Consultation Paper⁵⁸ are likely to fall outside any existing Hong Kong regulatory framework. We expect that such large players will rely on AIs and other regulated intermediaries to advise them on, or assist them with, the reporting and other requirements suggested in paragraph 172(3) of the Consultation Paper. However, we believe that it is imperative that any such advice or assistance is discretionary (not mandatory) and the large players remain responsible for their reporting requirements. There should be no advisory or agency reporting requirements imposed on AIs or regulated intermediaries in relation to large players.

We also suggest that regulatory guidance address potential conflicts of interest where an AI or regulated intermediary advises or assists a large player in relation to its requirements.

J Way forward

Thank you very much for the opportunity to provide feedback on the Consultation Paper.

HKAB and its members look forward to working with the HKMA and SFC in relation to the development of the proposed Hong Kong OTC derivatives regulatory framework.

In particular, please contact us if you have any queries in relation to the comments raised in this response. We would also be pleased to offer feedback on quantitative issues, such as implementation costs, which we understand are coming under increasing scrutiny by international regulators. Equally, we would also welcome ongoing updates about the progress of implementation in Hong Kong, including timing.

⁵⁸ Namely, "commercial entities and financial institutions who do not act as intermediaries but who are essentially price-takers or end users": paragraph 158(2), Consultation Paper.